Q. DEVELOPMENTS IN THE PRIVATE FOUNDATION AREA

1. Introduction

In the past year, there have been a number of significant developments in the private foundation area. A subcommittee of the House Ways and Means Committee has conducted a comprehensive review of the Tax Reform Act of 1969 and reported out amendments to the Act. In addition several significant determination responsibilities have been delegated to the field. The substantive rules involved in one of these delegations, the delegation of authority to issue determination letters on unusual grants, will be discussed in this topic. The rules involved in the other, the delegation of authority to issue determination letters on grant-making procedures under IRC 4945(g)(1) are discussed elsewhere in the 1984 CPE. Finally, the National Office began reconsideration of a significant revenue ruling issued in 1982.

2. Possible Legislation Changes

In late June the Subcommittee on Oversight of the House Ways and Means Committee conducted hearings intended to review the effectiveness of the Tax Reform Act of 1969. This review was undertaken for several reasons. A number of special exceptions to IRC 4943 had been introduced in the previous session of Congress. A presidential commission had recommended major revisions of the private foundation provisions. Also, a number of organizations in the private foundation community believed that the Tax Reform Act of 1969 had seriously impaired the growth of private foundations.

The hearings lasted three days. Both private foundations and special interest groups were represented. Some of the testimony defended the Tax Reform Act and the Service's administration of it. Other testimony called for repeal of several of the major provisions of the Act.

In October, the Ways and Means Committee approved a number of legislative changes as part of H. R. 4170, the proposed Tax Reform Act of 1983. Although Ways and Means Committee approval of legislative changes does not necessarily mean that the changes will become law, it is believed that some or all of the changes relating to private foundations will be enacted. The following is a list of the Committee's proposed changes and other recommendations:

A. Definition of Private Foundations and Public Charities

Proposed legislation exempts private operating foundations from the IRC 4940 tax and the expenditure responsibility rules under IRC 4945 if an organization (1) has been publicly supported for at least 10 years, (2) qualifies as a private operating foundation, and (3) has a governing body broadly representative of the general public. It is not entirely clear what organizations this is intended to reach, but it may be meant to apply to organizations that have previously been public charities.

B. Reduction in the 4940 Excise Tax

The proposed legislation reduces the excise tax on net investment income from two to one percent, provided that a foundation's current payout for charitable purposes is increased by an equivalent amount. A foundation would be allowed to measure its current payout for this purpose by using a five year average payout.

C. Amendments to Payout Requirements Under IRC 4942

The proposed legislation provides a limitation on the amount of grant administrative expenses which may be counted as qualifying distributions. These expenses would be limited to 15 percent of the amount of grants or contributions made, computed on the average payout over a five year period. Administrative expenses made directly for the active conduct of exempt activities of the foundation will not be treated as administrative expenses subject to the limitation.

A technical amendment to IRC 4942 would add to the required minimum payout certain loan repayments, proceeds from asset dispositions, and unused set-asides.

D. Amendments to Excess Business Holding Rules Under IRC 4943

With respect to excess business holdings acquired after 1969, by gift or bequest, the legislation would provide IRS with discretionary authority to grant an extension of an additional five years for divestiture of such holdings on a showing by a foundation of good cause plus good faith efforts to dispose of the excess holdings within the five year period permitted under present law.

With respect to excess business holdings held by a private foundation on May 26, 1969:

(1) Present law divestiture requirements would be retained.

(2) An exception to the "downward-ratchet rule" would be enacted.

(3) Eligibility for the 20 year Phase One period would be clarified.

E. <u>Amendment to Voter Registration Rules Under IRC 4945(f)</u>

The proposed legislation repeals the provision that a private foundation may support a voter registration drive only if the drive is conducted in at least five states. The other requirements under IRC 4945(f) would be retained, thus the registration drive must be nonpartisan and cannot be confined to one election period.

F. <u>Review of Expenditure Responsibility Regulations (IRC 4945(h))</u>

The Ways and Means Committee directed the Treasury Department to review the expenditure responsibility regulations for purposes of modifying requirements which are found to be unduly burdensome or unnecessary. As part of its review, Treasury is to modify the required grantor reports to the IRS and to report to the Committee on its review and modification.

G. <u>Review of Regulations on Reliance on IRS Determination of Grantee Status</u>

The Committee directed Treasury to extend the advance ruling period during which qualifying new organizations are considered public charities to five years, and to amend the regulations to permit greater reliance on IRS classifications concerning new organizations in the first five years of their existence.

H. <u>Definition of Family Member Under IRC 4946(d)</u>

The legislation provides that lineal descendants of a disqualified person who are considered members of the family of that individual, and, as such, disqualified persons, are the individual's children, grandchildren, and great-grandchildren, and the spouses of such descendants.

I. <u>Termination of Status as Substantial Contributor Under IRC 507(d)(2)</u>

The legislation provides that a person will not continue to be treated as a substantial contributor as of the close of a taxable year of a foundation if (1) neither the person nor any related person made a contribution to the foundation at any time within the 10 year period ending at the close of the taxable year; (2) at no time during the 10 year period was that person or any related person a foundation manager; and (3) the aggregate contributions made by such person and related persons are insignificant compared to the aggregate amount of contributions to that foundation by one other person.

J. Abatement of First-Tier Excise Taxes Under IRC 4942-4945 in Certain Cases

The legislation provides discretionary authority for the IRS to abate first-tier Chapter 42 private foundation taxes other than the IRC 4941 tax on self-dealing, if a violation was due to reasonable cause and not to willful neglect, and has been corrected within the appropriate correction period. A violation due to ignorance of the law will not qualify for an abatement.

K. Public Disclosure and Accessibility of Information on Foundations to Grant Applicants Under IRC 6104(d)

The Ways and Means Committee directed IRS to enforce fully present law rules relating to private foundation annual information returns (Form 990-PF), including the imposition, in appropriate cases, of penalties for failure to file a complete return where the return as filed fails to provide all required information. The Committee also called upon IRS to facilitate the flow of appropriate information to those State officials who are entitled to such information and to coordinate more closely with the States to maximize the benefits to be derived from such information.

The Committee also would require private foundation notices published annually in a newspaper to include a telephone number.

3. Unusual Grants

Rev. Proc. 83-36, 1983-1 C.B. 763, updates the Service's procedures for issuing determination letters. One of the significant provisions in the revenue procedure concerns unusual grants under IRC 170(b)(1)(A)(vi) and 509(a)(2). Section 5.03 provides that a request for a ruling on an unusual grant may be treated as a request for a determination letter on private foundation status, and may, therefore, be handled by the key districts. The procedures for handling these requests are outlined in two other revenue procedures. The procedures for determinations on foundation status are contained in Rev. Proc. 76-34, 1976-2 C.B. 656. Where an unusual grant issue is not clearly covered by statute, regulations, etc., technical advice should be requested under the procedures described in Rev. Proc. 80-26, 1980-2 C.B. 671.

The unusual grant rules were developed in the definitions of publicly supported organizations under IRC 170(b)(1)(A)(vi) and 509(a)(2) after the enactment of the Tax Reform Act of 1969. Congress was concerned that an organization's normal pattern of support might be distorted by large "one-time" gifts or bequests and that the distortion might lead to the organization's loss of public charity status. Congress specifically indicated that "modifications [in the support rules] are expected to be made, however, to take into account the likelihood that on occasion an organization may receive an unusual grant or bequest which should not affect its status."

Foundations are not the only ones that might be affected were there no special rules for unusual grants. Individual contributors might lose deductions under IRC 170 and foundations making grants might be subject to tax under IRC 4945.

Regs. 1.170A-9(e)(4)(v)(b) and 1.509(a)-3(c)(1)(iii) state that once an organization has been classified as a publicly supported organization described in IRC 170(b)(1)(A)(vi) or 509(a)(2), the treatment of grants and contributions and the status of grantors and contributors to the organization under IRC 170, 507, 545(b)(2), 556(b)(2), 642(c), 4942, 4945, 2055, 2106(a)(2), and 2522 will not be affected by a subsequent loss of classification as a publicly supported organization until notice of loss of classification is published. However, a grantor or contributor may not rely on such an organization's classification if the grantor or contributor is responsible for or aware of a "substantial and material" change in the organization's support causing loss of classification as a publicly supported organization. For example, a "substantial and material" change in sources of support may result from the receipt of an unusually large contribution that does not qualify as an unusual grant under Regs. 1.170A-9(e)(6)(ii) or 1.509(a)-3(c)(3). The contributor, even though he or she relied on a letter classifying the organization as an IRC 170(b)(1)(A)(vi) or 509(a)(2) organization, may not receive the benefit of the deduction limits under IRC 170(b)(1)(A)(vi) and 170(b)(1)(A)(viii) if as a result of his or her contribution the organization loses its classification as a public charity. Similarly, a grant-making private foundation might find itself subject to the IRC 4945(a) tax on taxable expenditures because it may not have followed expenditure responsibility requirements of IRC 4945(d)(4) for grants to non-public organizations if its grant is not an unusual grant and the grantee organization loses its classification as a public charity.

The receipt of an "unusual grant" as defined in Regs. 1.170A-9(e)(6)(ii) and 1.509(a)-3(c)(3) will not cause a "substantial and material" change within the meaning of Regs. 1.170A-9(e)(4)(v)(b) and 1.509(a)-3(c)(1)(iii). Thus, a grantor or contributor who makes a grant or contribution which is an "unusual grant" to an IRC 170(b)(1)(A)(vi) or 509(a)(2) organization will not be responsible for a "substantial and material" change in that organization's sources of support.

The unusual grant rules in both IRC 170 and 509(a)(2) were drafted at the same time and approached the problem in the same way. Reg. 1.170A-9(e)(6)(ii) provides that for purposes of determining whether the one-third support test or the 10 percent "facts and circumstances test" is met, one or more contributions may be excluded from both the numerator and the denominator of the applicable percent-of-support fraction if the amount in question is considered an unusual grant. Reg. 1.509(a)-3(c)(3) provides a similar exclusion and adds that the amount may be excluded from the denominator of the one-third gross investment income fraction.

The exclusion is intended to apply to substantial contributions and bequests from disinterested parties that are attracted by reason of the publicly supported nature of the organization; are unusual or unexpected with respect to the amount thereof; and would, by reason of their size, adversely affect the publicly supported status of the organization. Grants considered excludable as unusual grants that are payable to an organization over a period of years can be excluded from the organization's support computation in the amount actually received in each taxable year. However, amounts of investment income earned by a recipient organization from an unusual grant do not qualify as part of the unusual grant that may be excluded.

The regulations set forth a number of determining factors for qualifying excludable grants. Although all pertinent facts and circumstances are considered, and although no particular single factor is determinative, the following factors are considered in determining whether the unusual grant requirements have been met:

A. Whether the contribution is made by any person who created the organization, previously contributed a substantial part of its support, or endowment, or stood in a position of authority, such as a foundation manager, with respect to the organization. Non-related contributors are given more favorable consideration than contributions made by an individual with a prior involvement with the organization.

B. Whether the contribution is a bequest or an inter vivos transfer. A bequest will ordinarily be given more favorable consideration than an inter vivos transfer.

C. Whether the contribution is in the form of cash, readily marketable securities, or assets which further the exempt purpose of the organization, such as a gift of a painting to a museum.

D. For established organizations, whether, prior to receipt of the particular contribution, the organization has carried on an actual program of public solicitation and exempt activities, and has been able to attract a significant amount of public support.

E. Whether the organization may reasonably be expected to attract a significant amount of public support subsequent to the particular contribution. In this connection, continued reliance on unusual grants to fund an organization's current operating expenses, as opposed to providing new endowment funds, may be evidence that the organization cannot reasonably be expected to attract future support from the general public.

F. Whether prior to the year in which the particular contribution is received the organization met the one-third support test without the benefit of any exclusions of unusual grants.

G. Whether either the contributor or any related individual continues directly or indirectly to exercise control over the organization.

H. Whether the organization has a representative governing body.

I. Whether material restrictions or conditions have been imposed by the transfer upon the transferee in connection with the transfer.

Reg. 1.509(a)-3(c)(6) contains the following seven examples in which the principles pertaining to unusual grants are applied.

Example (1). For the years 1970 through 1973, X, an organization exempt under section 501(c)(3) which makes scholarship grants to needy students of a particular city, received support from the following sources:

1970	
Gross receipts (general public)	$35,000
Contributions (substantial contributors)	36,000
Gross investment income	29,000
Total support	100,000
1971	
Gross receipts (general public)	34,000
Contributions (substantial contributors)	35,000
Gross investment income	31,000
Total support	100,000
1972	
Gross receipts (general public)	35,000
Contributions (substantial contributors)	30,000
Gross investment income	35,000
Total support	100,000
1973	
Gross receipts (general public)	30,000
Contributions (substantial contributors)	39,000
Gross investment income	31,000
Total support	100,000

In applying section 509(a)(2) to the taxable year 1974 on the basis of subparagraph (l)(i) of this paragraph, the total amount of support from gross receipts from the general public ($134,000) for the period 1970 through 1973 was more than one-third, and the total amount of support from gross investment income ($126,000) was less than one-third, of its total support for the same period

($400,000). For the taxable years 1974 and 1975, X is therefore considered "normally" to receive more than one-third of its support from the public sources described in section 509(a)(2)(A) and less than one-third of its support from gross investment income referred to in section 509(a)(2)(B) since due to the pattern of X's support, there are no substantial and material changes in the sources of the organization's support in these years. The fact that X received less than one-third of its support from section 509(a)(2)(A) sources in 1973 and more than one-third of its support from gross investment income in 1972 does not affect its status since it met the "normally" test over a 4-year period.

Example (2). Assume the same facts as in example (1) except that in 1973 X also received an unexpected bequest of $50,000 from A, an elderly widow who was interested in encouraging the work of X, but had no other relationship to it. Solely by reason of the bequest, A became a disqualified person. X used the bequest to create five new scholarships. Its operations otherwise remained the same. Under these circumstances X could not meet the 4-year support test since the total amount received from gross receipts from the general public ($134,000) would not be more than one-third of its total support for the 4-year period ($450,000). Since A is a disqualified person, her bequest cannot be included in the numerator of the one-third support test under section 509(a)(2)(A). However, based on the factors set forth in subparagraph (4) of this paragraph, A's bequest may be excluded as an unusual grant under subparagraph (3) of this paragraph. Therefore, X will be considered to have met the support test for the taxable years 1974 and 1975.

Example (3). In 1970, Y, an organization described in section 501(c)(3), was created by A, the holder of all the common stock in M corporation, B, A's wife, and C, A's business associate. Each of the three creators made small cash contributions to Y to enable it to begin operations. The purpose of Y was to sponsor and equip athletic teams for underprivileged children in the community. Between 1970 and 1973, Y was able to raise small amounts of contributions through fund raising drives and selling admission to some of the sponsored sporting events. For its first year of operations, it was determined that Y was excluded from the definition of "private foundation" under the provisions of section 509(a)(2). A made small contributions to Y from time to time. At all times, the operations of Y were carried out on a small scale, usually being restricted to the sponsorship of two to four baseball teams of underprivileged children. In 1974, M recapitalized and created a first and second class of 6 percent nonvoting preferred stock, most of which was held by A and B. A then contributed 49 percent of his common stock in M to Y. A, B, and C continued to be active participants in the affairs of Y from its creation through 1974. A's contribution of M's common stock was substantial and constituted 90 percent of Y's total support for 1974. Although Y could satisfy the one-third support test on the basis of the four taxable years prior to 1974, a combination of the facts and circumstances described in subparagraph (4) of this paragraph preclude A's contribution of M's common stock in 1974 from being excluded as an unusual grant under subparagraph (3) of this paragraph. A's contribution in 1974 constituted a substantial and material change in Y's sources of support within the meaning of subparagraph (1)(ii) of this paragraph and on the basis of the 5-year period prescribed in subparagraph (1)(ii) of this paragraph (1970 to 1974), Y would not be considered as "normally" meeting the one-third support test described in paragraph (a)(2) of this section for the taxable years 1974 (the current taxable year) and 1975 (the immediately succeeding taxable year).

Example (4). M, an organization described in section 501(c)(3), was organized in 1971 to promote the appreciation of ballet in a particular region of the United States. Its principal activities will consist of erecting a theater for the performance of ballet and the organization and operation of a ballet company. The governing body of M consists of 9 prominent unrelated citizens residing in the region who have either an expertise in ballet or a strong interest in encouraging appreciation of the art form. In order to provide sufficient capital for M to commence its activities, X, a private foundation, makes a grant of $500,000 in cash to M. Although A, the creator of X, is one of the nine members of M's governing body, was one of M's original founders, and continues to lend his prestige to M's activities and fund raising efforts, A does not, directly or indirectly, exercise any control over M. By the close of its first taxable year, M has also received a significant amount of support from a number of smaller contributions and pledges from other members of the general public. Upon the opening of its first season of ballet performances, M expects to charge admission to the general public. Under the above circumstances, the grant by X to M may be excluded as an unusual grant under subparagraph (3) of this paragraph for purposes of determining whether M meets the one-third support test under section 509(a)(2). Although A was a founder and member of the governing body of M, X's grant may be excluded.

Example (5). Assume the same facts as example (4). In 1974, during M's third season of operations, B, a widow, passed away and bequeathed $4 million to M. During 1971 through 1973, B had made small contributions to M, none exceeding $10,000 in any year. During 1971 through 1974, M had received approximately $550,000 from receipts for admissions and contributions from the general public. At the time of B's death, no person standing in a relationship to B described in section 4946(a)(1)(C) through (G) was a member of M's governing body. B's bequest was in the form of cash and readily marketable securities. The only condition placed upon the bequest was that it be used by M to advance the art of ballet. Under the above circumstances, the bequest of B to M may be excluded as an unusual grant under subparagraph (3) of this paragraph for purposes of determining whether M meets the one-third support test under section 509(a)(2).

Example (6). O is a research organization described in section 501(c)(3). O was created by A in 1971 for the purpose of carrying on economic studies primarily through persons receiving grants from O and engaging in the sale of economic publications. O's five-member governing body consists of A, A's sons, B, and C, and two unrelated economists. In 1971, A made a contribution to O of $100,000 to help establish the organization. During 1971 through 1974 A made annual contributions to o averaging $20,000 a year. During the same period, O received annual contributions from members of the general public averaging $15,000 per year and receipts from the sale of its publications averaging $50,000 per year. In 1974, B made an inter vivos contribution to O of $600,000 in cash and readily marketable securities. Under the above circumstances, B's contribution cannot be excluded as an unusual grant under subparagraph (3) of this paragraph for purposes of determining whether O meets the one-third support test.

Example (7). P is an educational organization described in section 501(c)(3). P was created in 1971. The governing body of P has 9 members, consisting of A, a prominent civic leader and 8 other unrelated civic leaders and educators in the community, who also participated in the creation of P. During 1971 through 1974, the principal source of income for P has been receipts from the sale of its educational periodicals. These sales have amounted to $200,000 for this period. Small contributions amounting to $50,000 have also been received during the same period from members of the governing body, including A, as well as other members of the general public. In 1974 A contributed $750,000 of the nonvoting stock of Y, a closely held corporation. A retained a substantial portion of the voting stock of Y. By a majority vote, the governing body decided to retain the Y stock for a period of at

> least 5 years. Under the above circumstances, A's contribution of the Y stock cannot be excluded as an unusual grant under subparagraph (3) of this paragraph for purposes of determining whether P meets the one-third support test.

The Private Foundation Handbook, IRM 463(1) contains the following examples of situations involving unusual grants:

[Example not shown here]

Under certain circumstances, the exclusion of a grant or contribution may have an adverse impact on an organization's public charity status. For this reason Rev. Proc. 81-7, 1981-1 C.B. 621, amplifies the adverse impact rules of Regs. 1.170A-9(e)(6)(ii) and 1.509(a)-3(c)(3). Section 3.02 of Rev. Proc. 81-7 provides that a grant or contribution will adversely affect the status of an organization under IRC 170(b)(1)(A)(vi) or 509(a)(2) only if the organization otherwise meets the support tests in the year being tested without benefit of the grant or contribution. The revenue procedure provides the following two examples which illustrate this rule.

> .01 During the years 1975-1978, A, a section 509(a)(2) organization, received aggregate support of $350,000. Of this amount, $105,000 was received from grants, contributions and receipts from admissions that are described in sections 509(a)(2)(A)(i) and (ii). An additional $150,000 was received from grants and contributions from substantial contributors described in section 507(d)(2) of the Code (disqualified persons under section 4946(a)(1)(A)). The remaining $95,000 was gross investment income as defined in section 509(e) of the Code. Included in the contributions from disqualified persons was a contribution of $50,000 from X. X was not a substantial contributor to the organization prior to the making of this contribution. In addition, all of the other requirements of SEC. 3.01 were met with respect to X's contribution. If X's contribution is excluded from A's support by reason of the fact that it is an unusual grant, A will have received, for the years 1975-1978, $105,000 from sources described in sections 509(a)(2)(A)(i) and (ii), $100,000 in grants and contributions from disqualified persons, and $95,000 in gross investment income. Therefore, if X's contribution is excluded from A's support, A meets the requirements of the section 509(a)(2) support test for the year 1979 because more than one-third of its support is from sources described in sections 509(a)(2)(A)(i) and (ii) and no more than one-third of its support is gross investment income. Thus, X's contribution adversely affects the status of A

within the meaning of SEC. 3.02 and since the guidelines of SEC. 3.01 are met, the contribution is excludable as an unusual grant. X will not be considered responsible for a "substantial and material" change in A's support.

The computations to show the effect of excluding X's contribution from A's support are as follows:

Aggregate support received by A during the tax years from 1975 through 1978		$ 350,000
Less: Contribution from X		50,000
Aggregate support of A less contribution from X		$ 300,000
Gross investment income received by A as a percentage of A's total support (less the contribution of $ 50,000 from X) -	$\frac{\$\ 95,000}{\$\ 300,000}$	= 31.67%
Grants, contributions, and receipts from admissions described in sections 509(a)(2)(i) and (ii) received by A as a percentage of A's aggregate support (less the contribution of $ 50,000 from X)	$\frac{\$\ 105,000}{\$\ 300,000}$	= 35%

.02 Under the same facts, except that for the years 1975-1978, A received $100,000 from grants or contributions from disqualified persons instead of $150,000, the result would be different. In this case, if X's contribution is excluded as an unusual grant, A will have received $105,000 from sources that are described in sections 509(a)(2)(A)(i) and (ii), $50,000 in grants and contributions from disqualified persons, and $95,000 in gross investment income. If X's contribution is excluded from A's support, A will have received more than one-third of its support from gross investment income and A would not meet the requirements of the section 509(a)(2) support test for the year 1979. Thus, even though all the requirements of SEC. 3.01 are met with respect to X's contribution, it is not excludable as an unusual grant because it does not adversely affect the status of A within the meaning of SEC. 3.02.

The computation to show the effect of excluding X's contribution from A's support are as follows:

Aggregate support received by A during the tax years 1975 through 1978	$ 300,000	
Less: Contribution from X	50,000	
Aggregate support of A less contribution from X	$ 250,000	
Gross investment income received by A as a percentage of A's total support (less the contribution of $ 50,000 from X)	$\frac{\$ 95,000}{\$ 250,000}$	= 38%

Rev. Proc. 81-7 also contains rules indicating the circumstances under which an unusual grant can be relied on by both grantors and contributors for purposes of the "substantial and material change" rules of Regs. 1.170A-9(e)(4)(v)(b) and 1.509(a)-3(c)(1)(iii). In view of the likelihood of a revision of the reliance rules pursuant to a congressional mandate, the extent to which these rules apply in future years is unclear. However, currently grantors and contributors can rely on the fact that grants and contributions with the following characteristics will be treated as unusual grants.

> 1 The grant or contribution is made by a person other than a person (or persons standing in a relationship described in section 4946(a)(1)(C) through (G) to that person) who created the organization or was a substantial contributor to the organization within the meaning of section 507(d)(2) prior to the grant or contribution.
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> 2 The grant or contribution is not made by a person (or persons standing in a relationship described in section 4946(a)(1)(C) through (G) to that person) who is in a position of authority such as a foundation manager (within the meaning of section 4946(b)) with respect to the organization or who otherwise has the ability to exercise control over the organization. Similarly, the grant or contribution is not made by a person (or persons standing in a relationship described in section 4946(a)(1)(C) through (G) to that person) who, as a consequence of a grant or contribution, obtains a position of authority or the ability to otherwise exercise control over the organization.
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> 3 The grant or contribution is in the form of cash, readily marketable securities, or assets that directly further the exempt

purposes of the organization, such as a gift of a painting to a museum.

4 The donee-organization has received either an advance or final ruling or determination letter classifying it as an organization described in section 170(b)(1)(A)(vi) or 509(a)(2) and, except in the case of an organization operating under an advance ruling or determination letter, the organization is actively engaged in a program of activities in furtherance of its exempt purpose.

5 No material restrictions or conditions (within the meaning of section 1.507-2(a)(8)) have been imposed by the grantor or contributor upon the organization in connection with the grant or contribution.

6 If the grant or contribution is intended to underwrite operating expenses, as opposed to financing capital items, the terms and amount of the grant or contribution are expressly limited to underwriting no more than one year's operating expenses.

4. Reconsideration of Rev. Rul. 82-223

Rev. Rul. 82-223, 1982-2 C.B. 301, considered whether the indemnification of a foundation manager by a private foundation in two situations constitutes an act of self-dealing under IRC 4941(d)(1)(E) or a taxable expenditure under IRC 4945(d)(5).

In Situation 1, the foundation suffered a loss of assets in a transaction involving its foundation manager, a disqualified person under IRC 4946(a)(1)(B). The foundation manager's actions were not willful or without reasonable cause. State officials brought suit against the manager under state laws relating to the mismanagement of funds of charitable organizations. During the trial the state and the foundation manager entered into a settlement agreement which required the manager to reimburse the foundation for the value of assets lost. Under an existing indemnification agreement, the foundation proposes to indemnify the manager for attorneys fees, court costs and the amount paid in settlement of the suit. State statutes relating to nonprofit organizations allow such an indemnification. The foundation proposes to indemnify the manager directly from its own assets and not pursuant to any policy of insurance, and to treat any amounts that it paid as part of the compensation paid to the manager.

In Situation 2, the private foundation proposes to authorize the payment of premiums for an insurance policy providing liability insurance to its foundation manager for all liabilities, including settlement amounts, arising from a judicial or administrative proceeding involving state laws relating to the management of funds of charitable organizations. The premiums paid by the foundation would be treated as part of the compensation paid to the manager.

Rev. Rul. 82-223 holds that in Situation 1, the private foundation's proposed indemnification of its foundation manager for attorneys fees and costs is not an act of self-dealing or a taxable expenditure, so long as the amounts indemnified do not cause the manager's total compensation to be excessive. The revenue ruling also holds that indemnification of the settlement amount is an act of self-dealing and a taxable expenditure. In Situation 2 the revenue ruling holds that the foundation's payment of premiums for an insurance policy is not an act of self-dealing or a taxable expenditure as long as the premiums are treated as compensation paid to the manager and the total compensation is not excessive.

The revenue ruling holding is based on an interpretation of the relationship between the following three sections of the regulations:

> Reg. 53.4941(d)-2(f)(1) provides, in part, that the payment by a private foundation of the premiums for an insurance policy providing liability insurance to a foundation manager for taxes imposed under Chapter 42 shall be an act of self-dealing unless such premiums are treated as part of the compensation paid to the manager;
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> Reg. 53.4941(d)-2(f)(3) provides that except as provided in Reg. 53.4941(d)-3(c), IRC 4941(d)(1) shall not apply to the indemnification by a private foundation of a foundation manager, with respect to his defense in a judicial or administrative proceeding involving either Chapter 42 or state laws relating to mismanagement of funds of charitable organizations, against all expenses (other than taxes, penalties, or expenses of correction) including attorneys fees, if (1) such expenses are reasonably incurred by him in connection with such proceedings, and (2) he has not acted willfully and without reasonable cause with respect to the act or failure to act which led to liability for tax under Chapter 42; and Reg. 53.4945-6(b)(2) provides, in part, that any expenditures for unreasonable administrative expenses, including compensation, consultant fees, and other fees for services rendered, will ordinarily be taxable expenditures under IRC

4945(d)(5) unless the foundation can demonstrate that such expenses were paid or incurred in the good faith belief that they were reasonable and that the payment or incurrence of such expenses in such amounts was consistent with ordinary business case and prudence.

The revenue ruling analyzes this relationship as follows:

> In Situation 1, the first issue presented is whether the foundation manager's attorney's fees, court costs, and the amount paid to settle the state mismanagement proceeding are "expenses" within the meaning of section 53.4941(d)-2(f)(3) of the regulations. As used in that section, the term "expenses" refers to costs incurred with respect to a foundation manager's defense of a state mismanagement proceeding. The attorney's fees and court costs incurred by the manager in this case are costs incurred with respect to the manager's defense of the state proceeding and are, therefore, "expenses" for purposes of section 53.4941(d)-2(f)(3).
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> The amount paid in settlement of the state proceeding is not, however, a cost associated with the manager's defense. Rather, it is a personal liability assumed by the foundation manager as part of the settlement agreement. Consequently, the settlement amount is not an "expense" for purposes of section 53.4941(d)-2(f)(3) of the regulations.
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> The second issue presented in Situation 1 is whether such expenses are taxable expenditures within the meaning of section 4945(d)(5) of the Code.
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> The foundation's payment of expenses for attorney's fees and court costs would ordinarily be treated as part of the compensation paid to the foundation manager and, if reasonable, would not be an unreasonable administrative expense under section 53.4945-6(b)(2) of the regulations. Such reasonable administrative expenses are incurred for charitable purposes within the meaning of section 170(c)(2)(B). On the other hand, the foundation's proposed indemnification of the settlement amount would constitute a payment in satisfaction of the foundation manager's personal liability. As such, the payment would primarily benefit the foundation manger and would be unreasonable administrative expense under section 53.4945-6(b)(2). Thus, the payment would constitute an expenditure for a purpose other than one of the charitable purposes specified in section 170(c)(2)(B).

> In Situation 2, the question presented is whether the foundation's payment of the premiums for an insurance policy providing liability insurance to a foundation manager for liabilities, including settlement amounts, arising from a state mismanagement proceeding would constitute an act of self-dealing under section 4941(d)(1)(E) of the regulations.
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> The provision of indemnification for liabilities through the purchase of insurance is a common practice which enable an organization to attract and retain qualified management personnel. The indemnification of a foundation manager by a foundation for liabilities arising under state laws related to the management of funds of charitable organizations is similar to the indemnification for Chapter 42 tax liabilities addressed in section 53.4941(d)-2(f)(1) of the regulations and the indemnification for liabilities arising under the securities laws addressed in Rev. Rul. 74-405. Based on the foregoing, the foundation's payment of the premiums for such an insurance policy would not be an act of self-dealing under section 4941(d)(1)(E) of the Code as long as the premiums paid to procure the insurance do not cause the total compensation paid to the foundation manager to be excessive. Similarly, these insurance premiums are not taxable expenditures within the meaning of section 4945(d)(5) and section 53.4945-6(b)(2) because such expenses constitute reasonable administrative expenses and, thus, are incurred for charitable purposes within the meaning of section 170(c)(2)(B).

The foundation community is very concerned about the impact of Rev. Rul. 82-223. Payment of insurance premiums indemnifying foundation managers for expenses incurred in defense of their activities as foundation managers is a common practice. The foundations argue that they would be unable to attract qualified managers unless they buy this kind of insurance. The foundations are particularly concerned with the revenue ruling's holding that premium payments would be considered part of a foundation manager's compensation. They argue that the payment of premiums is intended to benefit the foundations allowing them to attract top-flight management.

The Service is in the process of reconsidering Rev. Rul. 82-223 based on the arguments raised by the foundation community. If field offices encounter this issue, they should seek technical advice from the National Office.